

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Longville Analyst: Roger Lackey Bill Number: AB 1001
Related Bills: See Legislative History Telephone: 845-3627 Introduced Date: 02-23-2001
Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: California Spaceport Development Zone Act of 2001

SUMMARY

This bill would:

- Require the Trade and Commerce Agency (TCA) to designate spaceport development zones.
- Allow certain taxpayers in a spaceport development zone to claim multiple income tax incentives.:

This analysis will address the TCA provisions of the bill only as they impact the department's programs and operations or state income tax revenue.

PURPOSE OF THE BILL

The author's purpose is to create new economic development areas to attract businesses related to the development of spaceports in this state.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2002. However, the majority of the bill's R&TC provisions specify they would be operative for taxable years beginning on or after January 1, 2001. The provisions allowing the credits to reduce regular tax below tentative minimum tax and the sales or use tax credit for corporate taxpayers would be operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist the author in resolving the implementation and policy considerations discussed below.

Board Position:

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_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Alan Hunter for GHG

04/26/01

ANALYSIS

FEDERAL/STATE LAW

Existing federal law specifies the designation of empowerment zones and enterprise communities to provide economic revitalization of distressed urban and rural areas. The Secretary of Housing and Urban Development and the Secretary of Agriculture designated nine empowerment zones and 95 enterprise communities from areas nominated by state and local governments.

Qualified zone businesses operating in federal empowerment zones and enterprise communities are eligible to finance property with exempt facility private activity bonds. This exempt bond is the only tax incentive available to businesses operating in enterprise communities. Two additional tax incentives are available in empowerment zones: (1) qualified empowerment zone businesses are allowed an additional \$20,000 expense deduction under IRC Section 179, and (2) employers are entitled to a 20% tax credit for the first \$15,000 of wages paid to certain empowerment zone employees.

Under the Government Code, existing state law provides for the designation of 39 enterprise zones, Local Agency Military Base Recovery Areas (LAMBRA), a Targeted Tax Area (TTA), and two Manufacturing Enhancement Areas (MEA). Using specified criteria, TCA designates these economic development areas (EDAs) from the applications received from the local governing bodies. Enterprise zones are designated for 15 years (except enterprise zones meeting certain criteria may have their designations extended to 20 years). Eight LAMBRA designations are authorized, at least one from each of five regions (as specified) of the state. Currently, TCA has designated four of the eight LAMBRAs, and one other area has received conditional designation. Each LAMBRA designation is binding for eight years. The TTA was designated November 1, 1998, and the MEAs were designated October 1, 1998. Both the TTA and MEAs are binding for 15 years beginning January 1, 1998.

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within EDAs. These incentives include a sales or use tax credit, hiring credit, business expense deduction, and special NOL treatment. A discussion of each incentive, plus the employee wage credit and net interest deduction discussion for enterprise zones, follows.

Sales or Use Tax Credit

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property purchased for exclusive use in the EDA. The amount of the credit is limited to the tax attributable to EDA income. Qualified property is defined as follows:

- Machinery and machinery parts used for:
 - manufacturing, processing, assembling, or fabricating;
 - producing renewable energy resources; or
 - air or water pollution control mechanisms.
- Data processing and communication equipment.
- Certain motion picture manufacturing equipment.

In addition, qualified property must be purchased and placed in service before the EDA designation expires. The annual maximum aggregate cost of property eligible for the EDA sales or use tax credit is \$1 million for individuals and \$20 million for corporations.

Hiring Credit

A business located in an EDA may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an EDA and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the EDA and at least 50% must be performed inside the EDA. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax imposed on EDA income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach enterprise zone, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits and the taxpayer's deduction of any such wages as ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

Business Expense Deduction

A business located in an EDA may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the EDA. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. The basis of the property must be reduced by the amount of the deduction. The maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months after designation	Maximum deduction
0 to 24	\$40,000
25 to 48	30,000
48 and over	20,000

NOL Deduction

A business located in an EDA may elect to carry over 100% of the EDA NOLs to deduct from EDA income in future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity within the EDA.

Employee Wage Credit – Enterprise Zones

Certain disadvantaged individuals are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for this credit. The amount of the credit is 5% of "qualified wages," defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment within the enterprise zone, computed as though that income represented the taxpayer's entire taxable income.

Net Interest Deduction – Enterprise Zones

A deduction from income is allowed to certain lenders for the amount of net interest received on loans made to a trade or business located within an enterprise zone. Net interest is defined as the gross amount of interest received, less any direct expenses (e.g., commissions paid) incurred in making the loan. The loan proceeds must be used solely for business activities within the enterprise zone and the lender may not have an equity or other ownership interest in the enterprise zone trade or business.

General Incentive Limitation – Apportionment of Zone Income

For businesses operating inside and outside an EDA, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the EDA. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, and a double-weighted sales factor). This income is further apportioned to the EDA using a two-factor formula based on the property and payroll of the business.

THIS BILL

This bill would authorize a new type of EDA called a “spaceport development zone.” This bill would specify that TCA shall designate only a city, a county, or a city and county that meets certain criteria regarding the spaceport development zone. An eligible area must have received launch site designation from the U.S. Secretary of Transportation. A designation made by TCA would be binding for an indefinite period of time from the date of the original designation.

This bill would allow the TCA to designate an unspecified number of spaceport development zones.

This bill would give TCA the authority to audit the program of any jurisdiction in any designated spaceport zone, relating to the goals, objectives, and commitments made by the program at its designation date. The bill would provide specific ratings that would determine if the zone would continue or be de-designated. As such, the bill also provides TCA the authority to de-designate a zone.

This bill would allow taxpayers doing business or employed in a spaceport development zone the same tax benefits that are available in other EDAs, as described above. Also, this bill would allow the sales and use tax credit and the hiring credit to reduce regular tax below tentative minimum tax, as is allowed for other economic development area credits.

In addition, for banks and corporations, **this bill** would allow a net interest deduction to certain lenders with regard to indebtedness to businesses in a spaceport development zone similar to that described above.

IMPLEMENTATION CONSIDERATIONS

This bill would become effective January 1, 2002; although, the majority of the credit and deduction provisions would be operative for taxable years beginning on or after January 1, 2001. Since TCA is not authorized to designate a spaceport development zone until January 1, 2002, taxpayers would be ineligible for these incentives until the zone has been designated. In addition, wages paid to an employee hired prior to the spaceport zone designation date would never be eligible for the employer hiring credit or the employee wage credit.

The author may want to consider amending the credit and deduction operative dates to match the effective date of the bill.

Also, the corporate sales or use tax credit and the provisions allowing the credits to reduce regular tax below tentative minimum tax would not be operative until taxable years beginning on or after January 1, 2002, which may create confusion.

The hiring credit provision of the bill mirrors portions of the existing hiring credit for other EDAs; however, the language of the bill does not include the criteria for "disadvantaged and disabled" employees. It is unclear if this was an oversight or if it was the author's intent to exclude these criteria.

The hiring credit and the employee wage credit define the term "qualified employee" both for purposes of credit eligibility and for exclusion from eligibility. These definitions impose the additional requirement that the employer obtain certification that the employee meets the elements for a "qualified employee." This certification must be obtained from the Employment Development Department, the local county or city Job Training Partnership Act administrative entity, or the local county GAIN office or social service agency, as appropriate. While the bill does not specifically require that certification be obtained to meet the general eligibility requirements to claim the credit, the department has interpreted this same phrase in other hiring credits to require certification, otherwise the credit is denied. Moreover, there have been circumstances where taxpayers have been unable to obtain a required certification for similar incentives for reasons related to eligibility (for example, if the certifying agency is not providing certifications). It is unclear in those circumstances whether the taxpayer is eligible for the credit in the absence of obtaining the certification.

Due to the ambiguity of the certification requirement and the general eligibility requirement discussed above, the FTB has sponsored a legislative proposal to clarify the general eligibility and certification requirements. (See SB 1125, under Legislative History below.) To avoid the same ambiguity that exists with other hiring credits, the author may wish to clarify his intent with respect to the certification requirement of each credit by adopting amendments comparable to the amendments in SB 1125. The department can provide language to clarify the author's intent in this area.

The 40% business expense deduction for qualified property contains a recapture provision. It specifies that the deduction shall be recaptured if the property ceases to be used within the spaceport development zone "at any time before the close of the second taxable year after the property is placed in service." The department would interpret this recapture provision in a manner consistent with the Legislature's original intent for calculating the recapture period for similar incentives. It was the Legislature's intent then to look to the last day of the taxable year in which the qualified property was placed in service and then add two more taxable years after that date to determine the recapture period.

The recapture period also may be interpreted to begin in the taxable year the property was placed in service and require only two taxable years to satisfy the recapture provisions. Under the second interpretation, the first taxable year would be the taxable year the property was placed in service. The author may wish to clarify his intent on this issue to resolve any confusion that may occur between the FTB and taxpayers in regard to the proper interpretation.

LEGISLATIVE HISTORY

AB 2001 (Longville, 1999/2000) would have created the California Spaceport Development Zone Act of 2000, and would have provided the same criteria, credits, and deductions as this bill. This bill died in Senate Revenue and Taxation Committee.

SB 1185 (Senate Rev. and Tax. Committee, 2001/2002), sponsored by the FTB, would amend the EDA hiring credit statutes to clarify that there must be a voucher for each new employee and to permit a limited exception where no vouchering mechanism has been established.

OTHER STATES' INFORMATION

Currently, 29 other states have economic development areas that provide similar tax related incentives as those provided by California's EDAs. The number of EDAs varies from state to state. For example, California currently has 50 economic development areas, while **New York** has 58; **Florida**, 32; **Illinois**, 93; and **Michigan**, 23. No other state provides incentives to specifically encourage development of spaceports.

FISCAL IMPACT

Once the implementation considerations are resolved, this bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Tax Revenue Estimate

It is not possible to predict in advance the number and location of designated Spaceport Development Zones, the response of business entities to such zones due to the proposed tax incentives, or the amount of expenses qualifying for tax benefits in any given year.

Total revenue losses for the state's existing enterprise zones were over \$48 million (average of over \$1 million per zone) for tax year 1998. The highly technological nature of the proposed zones would indicate that revenue losses for spaceport zones could far exceed the experience of existing incentive zones, even in the short run.

ARGUMENTS/POLICY CONCERNS

Federal law prohibits discriminatory state taxation of interest on federal securities. This bill would allow a deduction related to interest received by lenders that lend money to taxpayers engaged in a trade or business in a spaceport development zone. This incentive, which provides a subsidy to non-federal securities, could be considered to result in a violation of the federal law prohibiting discriminatory state taxation of interest on federal securities.

The bill would allow TCA to designate spaceport development zones. However, the bill does not limit the number of zones TCA may designate or the length of time they would remain designated. Current economic development area provisions contain limits on the number of zones or areas that may be designated and specify a time period for when the zone or area will expire.

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